LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

LM Capital Group Perspectives

Investment Insights
4Q 2023

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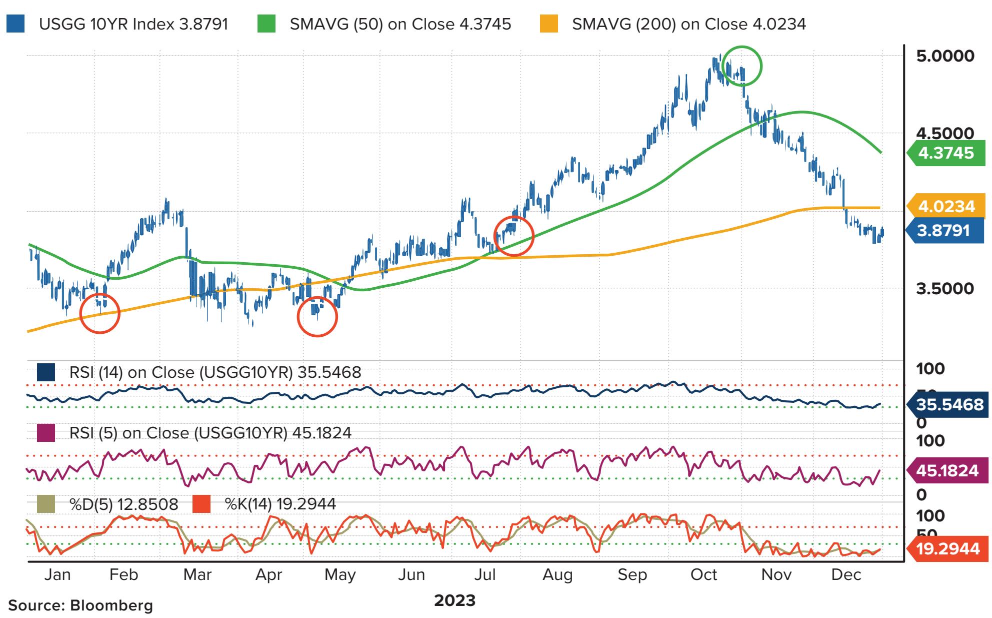
Santa's Elf – Chairman Powell

The markets continue to stare down a road full of binary economic data, with seemingly no further conviction about the direction of the world's economy than was had a year ago. Geopolitical tensions rose again this year but the markets continued to shrug off each event, one after the other. Economic data remained mixed - with the market's main focus still on Nonfarm Payrolls and CPI/PCE inflation data - while the consumer continued to provide strength for some solid GDP prints, though we know much of that spending is beginning to put real pressure on credit card and other loan balances. The headline CPI peaked way back in June 2022 at 9.1%, accompanied by fears it would remain sticky and possibly reaccelerate but markets reignited their optimism in 2023 and witnessed some big disinflationary moves to settle at the last print of 3.1% in mid-December. Much of that was due to stabilizing supply chains, normalizing commodity prices and less demand for core goods but also a helping hand from the monetary policy front.

10yr Treasury



Source: Bloomberg

The year's biggest buzz word, shouted with enthusiasm by tech CEO's on almost every quarterly earnings call possible, was artificial intelligence (AI). It drove stock prices (and in some cases, bond prices) consistently higher each time the phrase was mentioned. Many other buzz words or statements during the year were positive, others were negative, but one thing was consistent: they usually faded quickly. We saw a few major instances of this kind of sentiment change with regard to certain FOMC monetary policy statements throughout the year. You can almost pinpoint them on the 10yr Treasury chart without even knowing the day they occurred – but to help convey the point, I've circled them for you on the chart below (**red** for hawkish, **green** for bullish). Again, we're not talking about changes in the overnight rate here, just highlighting change in sentiment of the statement or press conference and the markets' reaction to show how quickly these positive or negative drivers shifted the flows.

Quarter in Review

After the slight reality check in the third quarter, the last three months of the year saw strong returns across most major asset classes. Growing excitement that central banks will cut interest rates sooner in 2024 than previously expected resulted in an 'almost everything rally'. Coming into the final quarter of 2023, the market was comfortable that central banks had finished hiking but cautious about how long rates would remain at restrictive levels. A series of softer inflation prints in the US and Europe, however, was enough to remove those fears as investors shifted to expect pre-emptive cuts from the central banks. This view was compounded at the December FOMC meeting where the latest projections suggested three cuts during 2024.

As a fun exercise, let's look back and see just how good the market has been at predicting FOMC moves on a 12-month horizon. Below you can see how wrong the markets initial estimations have been year after year, simply by comparing the January dated World Interest Rate Probability assumptions against the true Fed Funds Target Rate chart. After already underestimating the year-end 2022 terminal rate by almost 300bps, the market was majorly wrong again in looking for a pivot to rate cuts mid-2023, with a terminal rate not even breaching 5%. Are they wrong again in assuming a 150bp lower terminal rate at year-end 2024, or is third time the charm?

Fed Funds Futures - 01/03/2022

Meeting	#Hikes/ Cuts	%Hike/ Cut	Imp. Rate Δ	Implied Rate
01/26/22	+0.030	+3.0%	+0.007	0.088
03/16/22	+0.680	+65.1%	+0.170	0.250
05/04/22	+1.060	+38.0%	+0.265	0.345
06/15/22	+1.565	+50.5%	+0.391	0.471
07/27/22	+1.870	+30.4%	+0.467	0.548
09/21/22	+2.333	+46.3%	+0.583	0.663
11/02/22	+2.544	+21.1%	+0.636	0.716
12/14/22	+3.010	+46.6%	+0.752	0.833
02/01/23	+3.238	+22.8%	+0.809	0.890

Fed Funds Futures - 01/02/2023

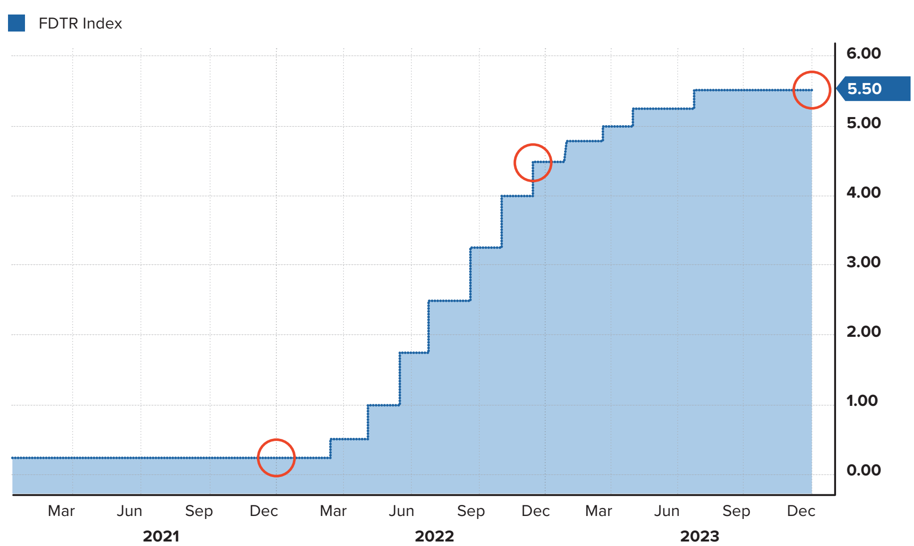
Meeting	#Hikes/ Cuts	%Hike/ Cut	Imp. Rate Δ	Implied Rate
02/01/23	+1.316	+131.6%	+0.329	4.662
03/22/23	+2.080	+76.4%	+0.520	4.853
05/03/23	+2.479	+39.9%	+0620	4.952
06/14/23	+2.494	+1.5%	+0.624	4.956
07/26/23	+2.030	-46.4%	+0.507	4.840
09/20/23	+1.680	-35.0%	+0.420	4.753
11/01/23	+1.574	-10.6%	+0.394	4.726
12/13/23	+0.669	-90.6%	+0.167	4.500
01/31/24	+0.330	-33.9%	+0.083	4.415

Fed Funds Futures - 12/29/2023

Meeting	#Hikes/ Cuts	%Hike/ Cut	Imp. Rate Δ	Implied Rate
01/31/24	-0.160	-16.0%	-0.040	5.288
03/20/24	-1.003	-84.3%	-0.251	5.077
05/01/24	-2.075	-107.2%	-0.519	4.809
06/12/24	-3.118	-104.4%	-0.780	4.548
07/31/24	-3.960	-84.2%	-0.990	4.338
09/18/24	-4.918	-95.8%	-1.229	4.098
11/07/24	-5.630	-71.3%	-1.408	3.920
12/18/24	-6.303	-67.2%	-1.576	3.752
01/29/25	-6.950	-64.7%	-1.738	3.590

While the predominant view among many is still to call for some type of recession later this year, others believe it's still possible to have a type of "Goldilocks" scenario where the economy continues to grow, the job market doesn't soften significantly, and inflation subsides. As with all things lately, no significant data or trend has established to help truly determine which scenario is more likely.

Federal Funds Target Rate - Upper Bound



Source: Bloomberg

The 10yr Treasury began the quarter at 4.57% and started off heading higher in October to tag a multi-year high of 5.02% intraday but reversed hard and fast for the rest of the year to finish much lower at 3.88%. The US Dollar finished much weaker this quarter on the backs of the supposed monetary policy pivot market participants expect. Tightening spreads also helped credit markets this quarter. Spreads on high yield and emerging market debt fell as the funding risk posed by higher for longer US rates for emerging market economies and riskier companies faded. Within the credit subsectors, industrials and utilities outperformed financials this quarter as the financial sectors shorter duration could not keep up with the total return of the longer duration sectors. Longer securities in both the Treasury and corporate space outperformed shorter ones significantly as the curves shape flattened bullishly.

The US Treasury (+5.66%), Government Agency Securities (+3.68%) sectors underperformed the broader Barclays US Aggregate Index's return of +6.82% on the quarter. The High Yield (+7.16%), Emerging Market Debt (+8.10%), Corporate (+8.50%), Non-Dollar (+9.21%) and Mortgage-Backed Securities (+7.48%) sectors outperformed the broader index's return.

Market Outlook

Economic data indicating a slowing economy with slightly lower inflation prompted a further pause in rate hikes by the FOMC and signaled the possibility of more cuts in 2024. It appears that the current Fed Funds rate represents the terminal rate in this hiking cycle. In Germany and the UK, we expect that recessionary pressures will force their rates lower before the FOMC begins cutting rates in the US. The labor market has eased slightly but still remains historically tight as evidenced by strong wage growth and recent union wage gains in the airline, auto and some services' sectors. Inflationary pressures appear contained except in the services sector. We continue to expect that inflation will be more difficult to push toward the Fed's 2.00% target as we enter 2024. Our proprietary Trend Identification Score remains bearish, calling for short duration and defensive positioning, although the score may lean towards a more neutral position in the US if inflation and the jobs market weaken faster than expected. Our outlook remains "higher for longer", implying that we are at the end of the Fed's rate hiking cycle but nowhere near the start of a decline in the Fed Funds rate despite the strong rally across the curve in the last two months. We remain in disagreement with market sentiment calling for a rate cut as early as the first quarter 2024, and believe the market has come down too far, too fast.

Although the US Dollar displayed weakness versus most currencies in November and December, we continue to remain cautious in the non-Dollar bond market at this time. Our positioning favors a rebound or stabilizing move in rates in the near term and no cut in rates by the FOMC in the immediate future. We are also cautious regarding the historically tight spreads in investment grade corporates, especially in the longer maturity paper.

We believe that short term interest rates have peaked. We will revisit our duration and sector allocation positioning in January based upon our upcoming Trend Score, as we expect 2024 to be a year where fixed income returns will be very positive following two years of very volatile results.

Patrick Faul
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More Questions than Answers: The Changing Nature of the "Agg"

While equity investors grapple with various facets of the "Magnificent 7" issue, fixed income investors are quietly grappling with our own mega issuer problem. It appears that it is inevitable that the US Government's share of the Bloomberg US Aggregate Index will grow and grow.

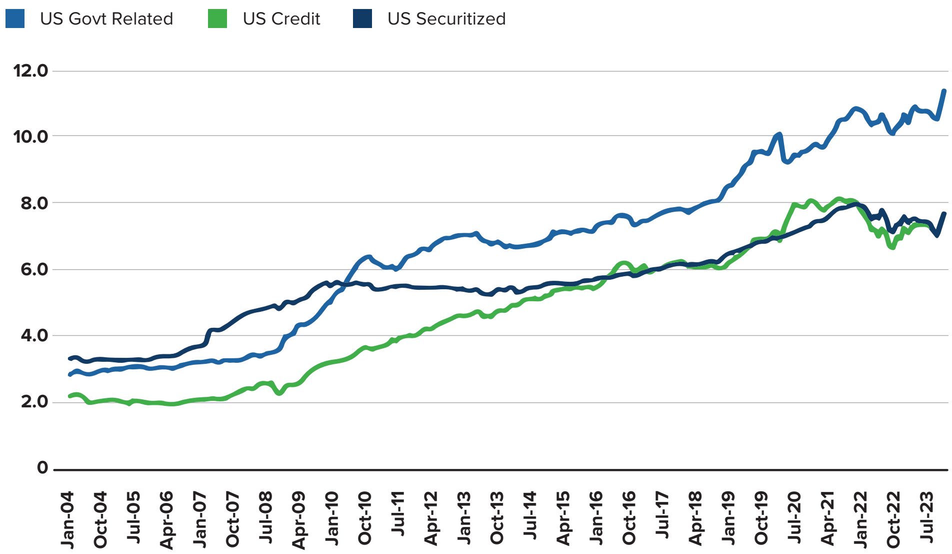
The first question suggested by the growth in US government-related debt that must be addressed by fixed income investors is: "where is my old Economics 101 textbook?". As we all flip to the index to look up "Crowding Out Effect", some additional obvious questions come to mind:

- Are deficit projections all that matter for Treasury issuance? Certainly not for the US Aggregate. Think about the US Treasury's constant refinancing decisions, particularly as they address the $9 trillion-plus coming due in 2024 (Chart 3). Recall that, generally speaking, only bonds with more than one year to maturity are index-eligible. A couple of hundred billion in 2024 maturities, sprinkled here and there among the longer maturities, may make a big difference. Look back at Chart 2, and think about the financing decisions that the Treasury will be making. How many short Treasuries can the money market funds and short-duration funds digest?

Past

Chart 1 - Bloomberg US Aggregate Index

Market Value Outstanding by Sector (trillions)

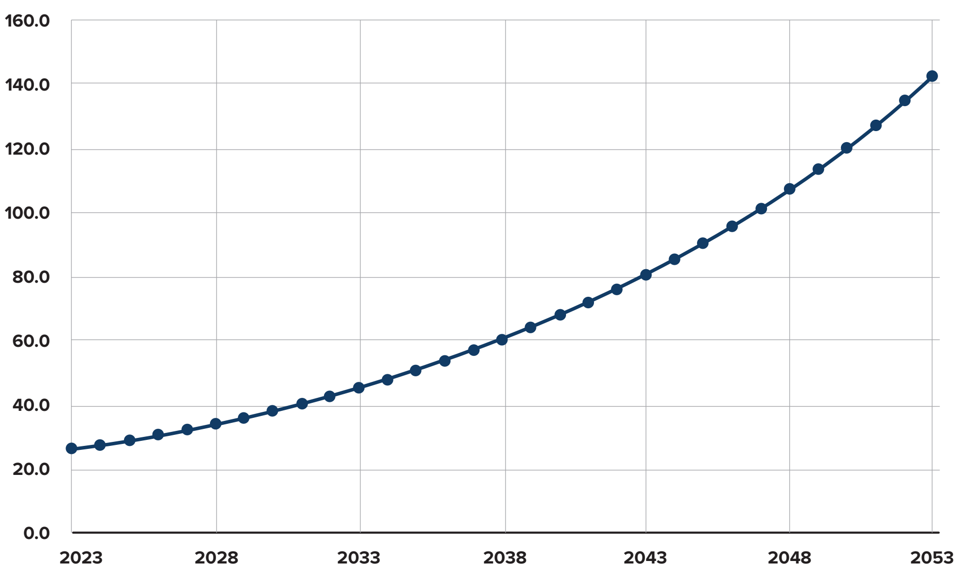


Source: Bloomberg

Future

Chart 2 - Congressional Budget Office estimate of Federal Debt held by the public

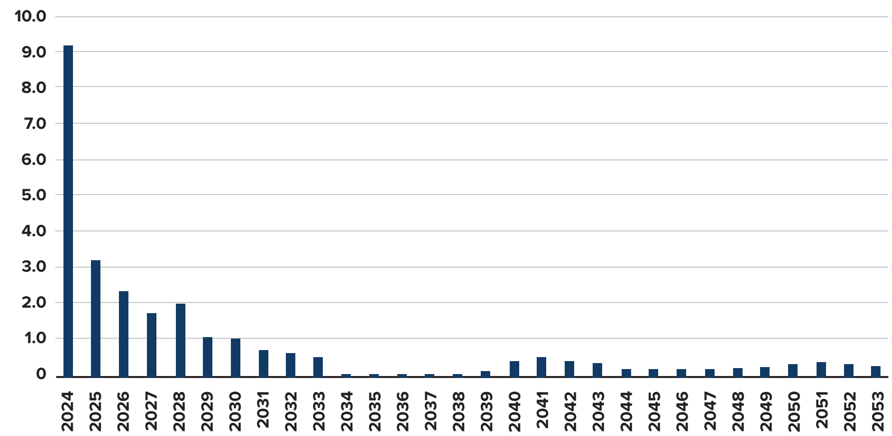
(trillions)



Source: Congressional Budget Office

- What happens to the spread on my core bond portfolio as the component weights change? Many moving parts influence spread changes, but there is no obvious evidence of a current crowding out effect. A spread chart for the last ten years does demonstrate that as the percentage of Treasuries increases (refer to Chart 1), the weighted average spread on the US Aggregate comes down, just as one would expect from the math of calculating weighted averages (Chart 4).

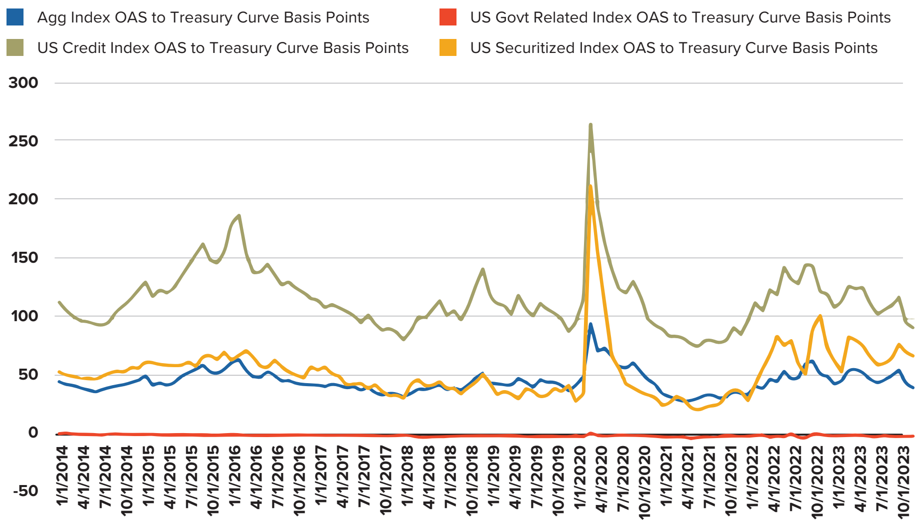
Chart 3 - US Government Borrowing by Year of Maturity
(trillions)



Source: Bloomberg

Now for some less obvious questions for which we don't have good answers:

Chart 4 - US Aggregate Index Option Adjusted Spread by Sector



Source: Bloomberg

- IF (that's a big IF) Treasury rates have to go up to attract new buyers for the additional issuance, what does that do to the borrowing costs for US Credit and US Securitized issuers?
- Will US Government borrowing crowd out US Credit and US Securitized borrowing, leading to less non-Treasury supply? Will that hypothetical reduced supply lead to lower credit spreads or will it lead to higher spreads as corporations try to attract buyers from the risk-free Treasuries?
- How will asset allocators react to the future, presumably less risky US Aggregate Index?
- How will Core Plus managers react as their Plus sectors become relatively smaller?

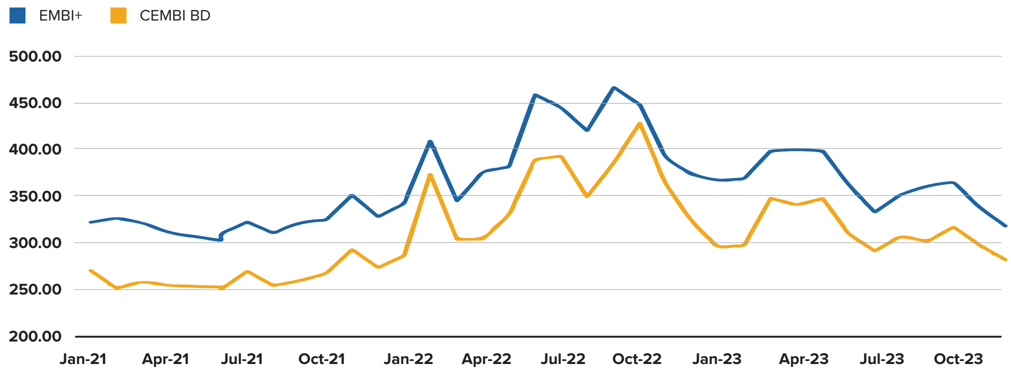
At LM Capital, our investment approach rests on the conviction that money represents a commodity where price, and interest rates, are governed by the laws of supply and demand, and that global economic, political, and social factors significantly influence this equation. As we navigate the stormy market, the looming US Treasury supply is our North Star. Like seafarers of old, we will always keep an eye on the sky for a change in the clouds. To further torture the analogy, our top-down investment process is both our barometer and our compass. The looming storms will affect sector allocations and security selection, with a constant goal of achieving attractive risk-adjusted returns.

Emerging Markets 4Q 2023 Review

Pablo Barrientos

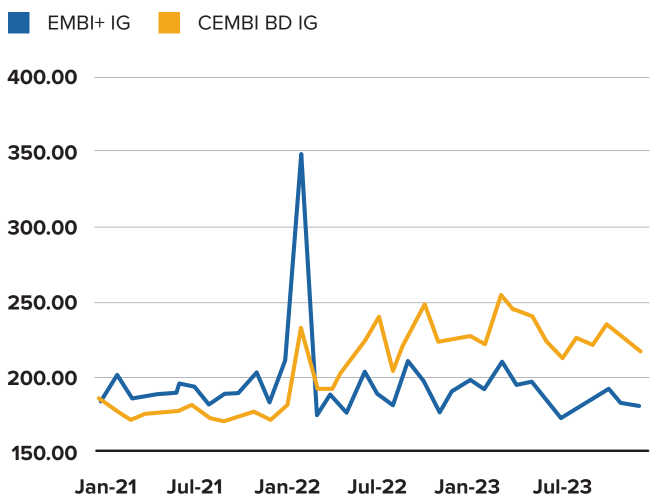
Senior Credit Analyst

Credit Spread Comparison: EM Sovereigns vs EM Corporates

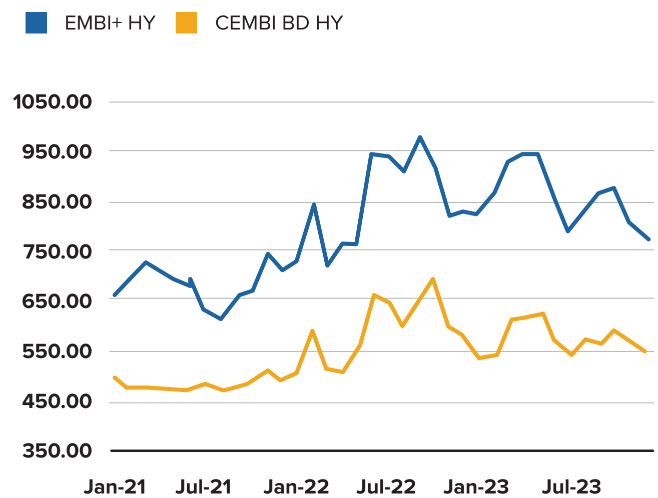


Source: Bloomberg

Investment Grade Spreads: Sovereign vs Credit



High Yield: Sovereign vs Credit



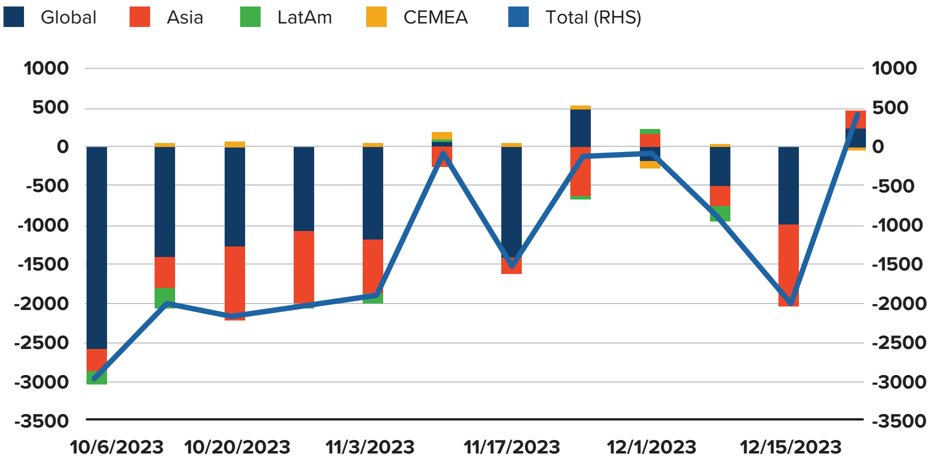
Source: Bloomberg, JPM USD EMBI+ Index (EM Sovereign bond Index), JPM USD CEMBI BD Index (EM Corporate bond index)

Aside from the US banking scare in March 2023, credit spreads for issuers in emerging markets continued their tightening trend from Q4 2022. Higher yields offered by emerging market issuers proved too good to pass as credit spreads gradually tightened through 2023 to end the year at spreads last seen during 2021. Following the December FOMC meeting that hinted at a potential end to the rate hiking cycle in the US, investor appetite for risk assets was turbocharged as seen by the increased demand for lower rated (aka Junk) debt across the globe. Over the last fifteen months, risk appetite has remained undeterred aided by strong growth and easing inflationary pressures in the face of a synchronized global tightening campaign not seen for decades. At current levels, credit spreads are priced for perfection with the expectation that global inflationary pressures will continue to ease without causing a severe recession. We think the fight to tame the last mile of inflation will be harder than priced by the markets and any upside surprises on that front would lead to a selloff in risk assets.

Led by Asia-focused funds, flows into EM debt-dedicated funds were net negative during the fourth quarter. However, as the market read the FOMC's statements as being done with rate hikes, appetite for riskier assets increased toward year end. Flows into Emerging Market Debt trended positive, recording inflows in the final week of December after 21 straight weeks of net outflows.

EM primary bond issuance remained soft during 4Q 2023, seeing mainly investment grade sovereign borrowers access the capital markets. Notably, Brazil issued its first bond under an ESG framework while Chile and Jamaica took advantage of investor appetite for local currency debt by raising CLP and JMD-denominated benchmarks, respectively.

EM Bond Fund Flows



Source: Morgan Stanley. Includes Hard, Local and Blended Currency funds.

In secondary markets, Israel sovereign and corporate bond spreads were impacted by the October 7th attacks, but have recovered significantly since then. Argentina bond prices increased +50% during the quarter as right-wing libertarian Javier Milei won the country's presidential election. On the other hand, Panama bonds were among the worse performers following the cancellation of First Quantum's mining contract and the ongoing draught in the canal that has redirected global shipping routes.

Political risk will be a major consideration across markets in 2024 as this will be the biggest election year in history. More than 60 countries representing half the world's population will go to the polls this year. In addition to the United States (Nov), presidential elections will take place in Taiwan (Jan), El Salvador (Feb), Indonesia (Feb), Russia (Mar), South Korea (Apr), India (Apr-May), Panama (May), Dominican Republic (May), Mexico (Jun) and Uruguay (Oct).

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